I. DEFINITIONS

Premises include the cost, less accumulated depreciation, of land and buildings actually owned and occupied (or to be occupied) by the bank, its branches or consolidated subsidiaries. This includes vaults, fixed machinery and equipment, parking lots used by customers or employees, real estate acquired for future expansion, and any outstanding mortgage or chattel liens thereon, whether or not the bank or its consolidated subsidiaries are liable. Interest costs associated with the construction of a building should be capitalized as part of the cost of the building. Bank premises also includes "leasehold improvements", which comprise two types of accounts: (1) construction of a building on leased property; and (2) capitalization of disbursements for vaults, alterations, and fixed machinery and equipment directly related to leased quarters and the costs of resurfacing or other improvements directly related to leased parking lots, all of which will become an integral part of the property and revert to the lessor upon expiration of the lease. Equipment includes all movable furniture, fixtures, and equipment of the bank, its branches, and consolidated subsidiaries, including automobiles and other vehicles, and any liens thereon. The amount of stocks, bonds, or other assets indirectly representing premises or equipment of non-majority-owned corporations is also included.

II. FIXED ASSETS ACCOUNTING

Fixed Assets - Owned

Fixed assets purchased after 1968 should be carried on the basis of cost, less accumulated depreciation. Balance sheet adjustments are required when fixed assets acquired after 1968 are carried at amounts materially less than cost reduced by an acceptable method of depreciation. Fixed assets capitalized at original cost should be depreciated over their estimated useful life, keeping in mind that land is not a depreciable asset. Any depreciation method, including straight-line, may be used provided it conforms to acceptable accounting principles.

The timing differences resulting from the use of a straight-line basis of accounting for book purposes and an accelerated method for tax purposes will eventually be reversed during future periods after the annual amount of tax-oriented depreciation falls below that taken on the books. Since the bank's tax liability in the later years will be greater than it would have been on the straight-line basis, the tax saving realized in the earlier years should be set aside in a deferred account to be applied to income tax expense of future periods when the timing difference is reversed.

A basic postulate of accounting theory is that all identifiable costs associated with bringing a fixed asset into productive use should be included in its historical cost. Statement of Financial Accounting Standards No. 34 states that the interest cost incurred in the construction phase of a building is to be capitalized as a part of the cost of the building. The accounting standard calls for capitalization of not only interest costs incurred on funds specifically borrowed to fund construction, but also provides for capitalization of interest costs where construction was financed from general funding sources which, in the case of a bank, is largely its deposit liabilities. The interest rate utilized on internally financed projects must not exceed the weighted average rate for all of the bank's interest-bearing deposits and liabilities. The credit resulting from the capitalization of imputed interest shall be reported as a reduction of "Other operating expenses" in the Report of Income.

Fixed Assets - Leased

Premises and equipment are often leased. Lease obligations can represent commitments which have had and will have a significant effect on bank earnings. The Financial Accounting Standards Board (FASB) has issued Statement No. 13, Accounting for Leases, which establishes generally accepted accounting principles regarding lease transactions. Any lease which at its inception meets one or more of the four following criteria and entered into on or after January 1977 by a lessee bank on an accrual basis of accounting must be accounted for as a property acquisition financed with a debt obligation and must be capitalized. The criteria are:

1. Ownership of the property is transferred to the lessee at the end of the lease term.

2. The lease contains a bargain purchase

option.

3. The lease term represents at least 75% of the estimated economic life of the leased property.

4. The present value of the minimum lease payments at the beginning of the lease term is 90% or more of the fair value of the leased property to the lessor at the inception date, less any related investment tax credit retained by or expected to be realized by the lessor.

The amount capitalized would be the present value of the minimum required payments over the noncancellable term as defined by the lease plus the present value of the payment required under the bargain purchase option, if any, less any portion of the payments representing administrative expenses such as insurance, maintenance and taxes to be paid by the lessor. The amortization period should be the life of the lease or a period consistent with the bank's normal depreciation policy, depending on which of the four criteria for a capital lease has been met.

Capitalized leases are to be included in the appropriate asset category depending on the nature of the asset financed through the capital lease, e.g., a capitalized building lease should be included in the bank building caption.

If the capital lease is not being reported as required in the above instructions, appropriate comments should be included on the Administration, Supervision and Control schedule. The comments should remind management of its responsibility for accurate reporting and include the recommendation that competent outside assistance be obtained if the bank lacks accounting expertise. In addition, if customary significance tests are met, amended Call Reports may be necessary. Bank management should also be instructed to advise the Regional Office of the results of its evaluation of the lease in question; a decision to not report the capitalization of the lease should be fully supported and documented.

Sale-Leaseback Transactions

Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. If the lease meets one of the criteria for treatment as a capital lease (refer to previous comments), the seller-lessee shall account for the lease as a capital lease. A loss must be recognized immediately for any excess of net book value over the fair value (economic value) of the property at the time of the sale. In the event a bank sells the property for an amount less than its fair value, for example, in order to obtain more favorable lease terms, the difference between the sale proceeds and fair value is an additional loss which must be deferred and amortized over the life of the lease. Profit resulting from a sale-lease-back transaction must generally be deferred and amortized over the life of the lease. Accordingly, the crediting of all or a part of the profit to the bank's income accounts, at the time of sale, will not be recognized as an acceptable practice. However, when less than substantially all of the property is leased back, FASB Statement No. 28 requires special handling for a resulting profit or loss. In some instances, the immediate recognition of a portion of the profit is called for. If the bank provides seller-financing to the purchaser in conjunction with a sale- leaseback transaction, FASB Statement No. 66 prevents immediate profit recognition in most circumstances unless a number of conditions are met. For example, the bank may have to defer recognizing any profit if the buyer's initial down payment or continuing investment does not meet certain criteria, if the bank as seller-lender allows its note to be subordinated to the claims of others, or if the bank retains substantially all the risks of ownership. Thus, FASB No. 66 prevents immediate profit recognition in certain transactions that would otherwise be realized under FASB No. 28.

Two additional supervisory guidelines have been established concerning some of the more general provisions found in FASB Statements No. 28 and 66. The first guideline relates to transactions in which either the property sold is subject to only a short-term leaseback or only a portion of the property sold is leased back. In these transactions, the allocation of profit on the sale of the bank building between the portion to be recognized immediately and the portion to be deferred should be based on an assumed minimum lease term of at least ten years, unless there is evidence to confirm that the lease is, in substance, a short-term lease. The deferred profit is amortized over this assumed minimum lease term.

The second guideline relates to transactions in which the bank finances the purchaser's acquisition in a sale-leaseback and the term of the note exceeds the lease term. In these transactions, the profit recognition and deferral should be based on the longer term of the note, unless there is evidence to confirm that the lease term is, in substance, shorter than the term of the note.

The requirements of FASB Statements No. 13, No. 28 and No. 66 are complex and examiners who have questions on lease capitalizations or sale-leaseback transactions should refer to appropriate accounting sources or, if necessary, contact the Regional Office.

III. EXTENT OF FIXED ASSETS INVESTMENT

A reasonable investment in premises and equipment is essential to the conduct of a banking business. However, overinvestment in facilities may weaken depositor protection, tie up capital, and burden earnings. Consequently, many states impose limits on fixed asset investments. Reluctance on the part of banks to keep their investments within statutory limits has resulted in a variety of alternative arrangements, such as organization of subsidiary or affiliate realty corporations, sale and leaseback transactions, and lease-purchase contracts. These arrangements are most common in connection with bank buildings, but in some instances are also being used in connection with equipment.

The realty corporation arrangement typically calls for investment in a subsidiary corporation and capitalization by the bank of an amount within State limitations, with the subsidiary corporation financing the additional cost of banking facilities in the mortgage market. The facilities are then leased to the bank by the subsidiary corporation at a rental that usually coincides with the mortgage payments. In one type of affiliate setup, a group of the bank's directors may form a corporation to hold title to the property and lease it to the bank.

Lease-purchase contracts or sale and leaseback arrangements should enable a bank at its option to acquire title to the fixed assets involved either during or at the expiration of the lease period.

Examiners should determine whether any arrangements or transactions concerning fixed assets involve "insiders" and, if so, that the transactions are made on substantially the same terms as those prevailing at the time for comparable transactions with noninsiders and do not involve more than normal risk or present other unfavorable features to the bank.

IV. ANALYSIS OF FIXED ASSETS

From an accounting standpoint, an investment in fixed assets is an essential cost of doing business and is much like a prepaid expense or a future operating expense frozen in time. Attention should be focused on the adequacy of depreciation, the reasonableness of the overall commitment, and current and prospective utilization of fixed assets in serving the present and future anticipated banking needs of the area served. Only under exceptional circumstances, such as the contemplated abandonment of bank premises, gross under-utilization due to obsolescence or permanently changed character of the area served, closed bank situations, or other similar extreme circumstances, do market value considerations assume any significance in the analysis of fixed assets.

Depreciation Costs as the Basis of Appraisal

Depreciation is an overhead cost of doing business, and the item being depreciated will have to be replaced when it ceases to provide a utility. an acceptable depreciation program allocates the original cost of the fixed asset over its estimated useful life. Failure to follow a realistic program of fixed asset depreciation distorts the statement of both the bank's condition and earnings.

Under normal circumstances, preparation of detailed depreciation schedules in harmony with the generally accepted accounting principle of capitalizing fixed assets at original cost and depreciating them over their useful life should not be necessary during the course of an examination, as the necessary information is generally available from the bank's income tax returns. In instances where tax depreciation and book depreciation are the same, little analysis of the book accounts will be required; however, if depreciation is accelerated for tax purposes only, further analysis of book value will be necessary to determine whether the fixed assets are being adequately depreciated. Where fixed assets have not been depreciated in conformance with accepted accounting principles and the accumulated but untaken depreciation is material, the matter should be discussed with management. In the absence of correction within a reasonable period, a Loss classification should be accorded the accumulated but untaken depreciation.

Overinvestment

The principal determinant of a possible overcommitment in equipment and facilities is the impact on earnings that such an investment has. Reference to pertinent schedules in the UBPR will reveal how the institution compares to its peers in terms of percent of total assets invested in premises and equipment, and percent of operating income absorbed by occupancy expense. This information, though not in itself conclusive, can be a useful starting point in the analysis. However, as long as the aggregate direct and indirect investment, including lease obligations, is reasonable in relation to the institution's earnings performance and capacity, the decision as to what constitutes an appropriate fixed assets commitment is within the purview of bank management.

V. FIRE AND EXTENDED COVERAGE ON BANK PREMISES, FURNITURE AND EQUIPMENT

Fire insurance may be obtained separately and relatively inexpensively, but the coverage would be quite narrow. Extended coverage indemnifies against losses from windstorms, cyclone, tornado, hail, and other so-called "acts of God", in addition to riot, civil commotion, etc. Usually not included is destruction caused by rising water, as distinguished from wind-driven rain (flood insurance may be available to cover this eventuality). Also not included is the steam boiler and the damage which may be caused by a malfunction thereof; a separate policy is available for this risk.

In many cases, fire insurance is subject to a coinsurance clause. This is intended to require the insured to maintain insurance equal to a certain percentage of the replacement cost, usually 80%. Only in the event that the insured carries the stated percentage, can it recover fully on partial loss. The amount of coverage of partial losses is limited to the relation between the coinsurance percentage and the percentage actually carried limited, of course, to 100%. For instance, if the replacement cost of a building is $100,000, the bank's insurance policy contains an 80% coinsurance clause, and carries only $60,000 insurance, a loss of $50,000 would be covered to the extent of $37,500 by the insurer. If $80,000 in fire insurance were carried by the insured, the loss would be covered totally, up to the full amount of the insurance carried ($80,000).